



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

OFFICE OF
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MEMORANDUM FOR ALFRED H. WHITLEY
DIRECTOR, TELECOMMUNICATIONS IS:T

FROM: Heather C. Maloy
Associate Chief Counsel
(Income Tax & Accounting)

SUBJECT: Cellular Telephone Expense Reimbursement

This responds to your request dated December 5, 2000, as well as subsequent inquiries from your staff, regarding the general tax rules that may apply to reimbursements of employees' cellular telephone expenses. I hope you find this information helpful.

BACKGROUND

Your office has responsibility for monitoring and accounting for the agency's cellular telephone usage. You would like to implement a program whereby, rather than providing employees with agency-owned cellular telephones, employees would be reimbursed for business use of their privately owned cellular telephones.

Under your proposed program, employees who elect to participate will be paid a flat monthly amount (for example, \$40) to reimburse costs, and the employees will be required to have the telephone available for use while on duty. However, the use of the cellular telephone will be incidental to the employee's duties – it will not be generally available for use by the agency. The employee uses the cellular telephone for personal purposes while off duty, and may use the telephone to make and receive a de minimis amount of personal calls while on duty. The program is not designed to reimburse the employee for the expenses of purchasing the cellular telephone, for activating the telephone, or for early service termination charges.

Typically cellular telephone customers pay a flat monthly fee, including applicable fees and taxes, for telephone service. A typical service plan will include a number of "free" calling minutes for the customer, and it may include other "free" calls, such as cellular-to-cellular calls or incoming calls. The plan may also provide a per-minute charge for telephone usage that exceeds the "free" minutes allowance, and other charges (such

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as directory assistance). Some plans provide a "one rate" service that charges the same rates for local and long distance calls, and other plans charge extra for calls outside of a designated calling area.

LAW AND ANALYSIS

An employer's payments to employees generally are included in the employee's gross income under § 61 of the Internal Revenue Code and are treated as wages subject to employment taxes. However, if an employer reimburses or pays advances for certain business expenses and meets the other requirements for an accountable plan, the payment is not wages includible in income or subject to employment taxes.

Section 62(a)(2)(A) provides that the term "adjusted gross income" means gross income minus deductible expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. Section 62(c) provides that for purposes of subsection (a)(2)(A), an arrangement shall not be treated as a reimbursement or other expense allowance arrangement if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement, or (2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses.

Under § 1.62-2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the three requirements of business connection, substantiation, and returning amounts in excess of expenses, set forth in paragraphs (d), (e), and (f), respectively, of § 1.62-2 ("the three requirements"). Section 1.62-2(c)(2)(i) provides that if an arrangement meets the three requirements, all amounts paid under the arrangement are treated as paid under an "accountable plan." The regulations further provide that if an arrangement does not satisfy one or more of the three requirements, all amounts paid under the arrangement are paid under a "nonaccountable plan."

Section 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an accountable plan are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes. However, § 1.62-2(c)(5) provides that amounts paid under a nonaccountable plan are included in the employee's gross income for the taxable year, must be reported to the employee on Form W-2, and are subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3306(b)-2, and 31.3401(a)-4 of the Employment Tax Regulations; see also § 1.6041-3(h)(1).

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An arrangement meets the business connection requirement of § 1.62-2(d) if it provides advances, allowances, or reimbursements for business expenses that are allowable as deductions by Part VI (§ 161 and the following), subchapter B, Chapter 1, and that are paid or incurred by the employee in connection with the performance of services as an employee. Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses.

Section 1.62-2(e)(2) provides that an arrangement that reimburses travel, entertainment, use of a passenger automobile or other listed property, or other business expenses governed by § 274(d) meets the substantiation requirement if information sufficient to satisfy the substantiation requirements of § 274(d) and the regulations thereunder is provided to the payor.

Cellular telephones are "listed property" under § 280F(d)(4)(A)(v). See Tarakci v. Commissioner, T.C.M. 2000-358. Therefore, the employee must adequately account to the employer in the manner set forth in § 1.274-5(f)(4) for the amount, time, uses, and business purpose of cellular telephone expenses. The employee generally must submit (1) an account book, diary, log, statement of expense, or similar record in which this information is recorded, and (2) documentary evidence. However, documentary evidence is not required for an expenditure of less than \$75. Also, employees of government agencies are not required to submit documentary evidence if the employer satisfies the requirements of Rev. Proc. 97-45, 1997-2 C.B. 499.

As for the third requirement, that amounts in excess of expenses be returned to the payor, the general rule of § 1.62-2(f) provides that this requirement is met if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated. Under § 1.62-2(g), an amount returned to the payor within 120 days after an expense is paid or incurred will be treated as having occurred within a reasonable period of time.

Thus, in order for the flat amount paid to employees to be treated as accountable plan payments, rather than as taxable wages, the amount must be equal to, or less than, the cellular telephone expenses incurred by the employee for business purposes. This determination will depend on the billing method of the employee's cellular telephone service. For example, it may be reasonable to allocate a flat monthly service plan fee between business and personal use based on the actual minutes of telephone use covered by the fee (such as the "free" minutes or the "free" cellular-to-cellular calls), with any additional charges allocated according to the nature of the charge.

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Employees must be obligated to return, within a reasonable period, any portion of the flat monthly amount paid by the employer that exceeds the substantiated cellular telephone expense allocable to business usage. If employees are not obligated to return amounts in excess of business expenses, the arrangement fails the business connection and return of excess requirements, and thus the entire monthly amount will be treated as employee wages, regardless of the nature of the cellular telephone usage.

In your request you also suggested that the flat monthly amount reimburses the expenses "on a lessor basis" – that is, that the flat monthly amount is akin to a rental payment for the cellular telephone usage. However, the cellular telephone is not generally available to the employer under the facts you propose, but rather is used incidentally to assist the employee in his or her duties. For example, the cellular telephone could not be reassigned to another employee. The payment is not a true rental payment, but rather is an expense reimbursement subject to the accountable plan rules. See Trans-Box Systems, Inc. v. United States, No. C-97-2768 THE (N.D. Cal. Aug. 28, 1998), aff'd without published opinion 225 F.3d 664 (9th Cir. 2000) ("vehicle lease" payments to couriers are wages).